

## Changes in R&D tax credits – no help for Small companies

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I was rather surprised to see the Treasury (Angela Eagle) announcement on R&D tax credits – apparently increasing the funding available. Surprised because this move was actually announced in the April 2007 Budget – why does it take so long to action? And surprised because in reality it does little for small companies. So let me provide some comment in the hope that this may stimulate a debate and action to increase the help to small and start-up enterprises.

Firstly, the announcement of an increase of £80million is bizarre. The R&D tax credit is not capped – it is open ended – if you qualify, you get it. Government only knows the outcome *after* the event. So what possible basis is there for suggesting an £80 million increase? In fact if you look at the actual support claimed by SMEs it has fallen from £210 million in 2002-03 to £180million in 2005-06 (the latest published figures). By contrast, the amount claimed by large companies has risen from £180 million in 2002-03 to £420 million in 2005-06. Large companies are obviously getting better at claiming the tax credit because during this time actual company spend on R&D did not increase at all.

What all this shows is that the R&D tax credit scheme is a mess and is not helping the small innovative companies who will fuel future growth in the economy. The small company R&D tax credit has been helpful (particularly the benefit to claim cash back) but it has clearly peaked and new initiatives are required to help small businesses.

The large company R&D tax credit by contrast is demonstrably poor value for tax payers money. There are two reasons for this. First, there is now ample evidence from economic research that while an R&D tax credit should increase business expenditure on R&D, its full impact will be felt only after a period of 10 years or more. In addition, the eventual benefits are limited compared to the costs involved. Economists conclude that for every £1 of permanent tax break an extra £1 will be spent on R&D. At the current level of spending on large company R&D tax credits of over £400 million per annum, this means that the Inland Revenue must forfeit £4 billion in taxes over 10 years to generate an annual increase in business R&D that reaches £400m only by the end of the 10-year period. And yet, even an increase of £400m per annum, if achieved, represents just 3 per cent of the current level of business spending on R&D (£13.4bn, in 2005). This is nowhere near the increase of 50 per cent that is required if the Treasury is to meet its target for R&D spending by industry of 2.5 per cent of GDP by 2014. Second, around 80 per cent of the value added to the UK's economy is generated by highly successful and innovative businesses, such as the financial services, the oil & gas sectors and the creative industries. These enterprises are significant users of technology but they traditionally report low R&D expenditure because of the very restrictive definition of R&D.

In the 2005 HM Revenue & Customs survey of R&D tax credit users, only “around a fifth, 19 per cent, of the successful claimants took the expected value of the tax credits into account when setting budgets.” So there is very little evidence to suggest that the initiative encourages businesses to do more R&D, and much evidence to suggest that tax credits are a heavy deadweight cost to taxpayers.

So what should be done? I would still keep the small company R&D tax credit but widen its scope. For the large firms R&D tax credit, a simple reform would be to move to an incremental R&D tax credit based on rolling averages and not paying below any peak year ie if they come off their 3 year moving average I would not

reward them for getting back to the peak, but only when the 3 year average exceeds it. Alternatively, shift the large firm tax credit to the TSB so the money stays in the innovation system, but now large companies have to compete for it.....and you give the TSB serious funds to play with. A further alternative would be to use some of the large company funding to support development projects for small/ startups along the lines suggested by David Connell in his report "Secrets of the Worlds largest seed capital fund"

A high profile debate is now required to quickly determine the most effective way for government to support business growth in the UK, particularly small innovative companies. I hope that the major industry organisations—the CBI, IoD, EEF, TUC, BCC—will put this issue high on their agendas.

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